

May 1, 2001

Ms. Donna Caton  
Chief Clerk  
Illinois Commerce Commission  
527 East Capitol Avenue  
Springfield, IL 62794

Re: Illinois-American Water Company et. al.  
Docket No. 00-0476

Dear Ms. Caton:

The Reply to Brief on Exceptions on behalf of the Illinois Industrial Water Consumers has been filed electronically with the Clerk of the Illinois Commerce Commission this date. Copies of the foregoing have been provided to parties on the service list.

Sincerely,

Edward C. Fitzhenry

ECF/alc

cc: Service List

Enclosure/31281

**STATE OF ILLINOIS  
ILLINOIS COMMERCE COMMISSION**

<b>ILLINOIS-AMERICAN WATER COMPANY,</b>	:	
<b>CITIZENS UTILITIES COMPANY OF ILLINOIS and</b>	:	<b>Docket 00-0476</b>
<b>CITIZENS LAKE WATER COMPANY</b>	:	
	:	
<b>Petition For Approval Of Proposed Reorganization and</b>	:	
<b>Affiliated Interest Agreements, Issuance of Common Stock</b>	:	
<b>and Debt Securities and Assumption of Affiliated Interest</b>	:	
<b>Agreements.</b>	:	

**REPLY TO BRIEF ON EXCEPTIONS ON BEHALF OF THE  
ILLINOIS INDUSTRIAL WATER CONSUMERS**

NOW COMES the Illinois Industrial Water Consumers (IIWC), by its attorneys, Lueders, Robertson & Konzen, and pursuant to 83 Ill. Adm. Code Part 200.830 submits its reply to the briefs on exceptions of Illinois-American Water Company (IAWC), Citizens Utilities Company of Illinois (CUCI), and the Illinois Commerce Commission Staff (Staff). IIWC's failure to respond to a particular argument or position of a party should not be construed as an endorsement of same.

**I. RESPONSE TO ILLINOIS-AMERICAN WATER COMPANY**

IAWC presses for the approval of its Shared Savings Proposal (SSP). The arguments in support of the SSP are a rehash of arguments previously presented in testimonies and briefs. For the most part, IAWC simply restates the arguments put forth by its witnesses, and does not explain why the evidence put forth by IAWC and Staff is wrong. Notwithstanding IAWC's many claims, the SSP remains a flawed methodology that is certain to create havoc with the ratemaking process in the future and will prove to be a detriment to ratepayers.

Before proceeding with a response to the various arguments or positions of IAWC, it is worth noting again the utility's insistence that if the acquisition goes forward and the SSP is not approved,

IAWC states its ability to raise necessary capital will be impaired and, consequently, so will its ability to provide least cost service. (IAWC Br. at 2; 36). In this respect, we agree that if the SSP is approved and IAWC is not able to later prove acquisition savings, its cost of capital will increase and this cost will eventually be passed onto ratepayers.

There does not appear to be any disagreement to the above. IWC has repeatedly stated, IAWC's late hour intent to hold harmless ratepayers from this increased cost of capital is a shallow promise. IAWC has failed to provide a methodology explaining how it will be able to discern that the increased cost of capital is due solely to the disallowance of recovery of acquisition savings, and not because of all the other known and unknown factors and variables that bear upon the utility's cost of capital. Because the ability to quantify the increased cost of capital due to this particular factor is not known and theoretically suspect, there remains a real risk that the increased cost of capital will be passed along to ratepayers.

So we ask the question, "Why approve a shared savings plan that is replete with problems as identified by IWC and the Staff, and then subject ratepayers to further rate increases?" Ratepayers would be better served by the Commission stating unequivocally that it is rejecting the SSP for the reasons identified by IWC in its briefs, including the recently filed brief on exceptions, and for the reasons identified in the Hearing Examiner's Proposed Order (Proposed Order).

A. Response To Arguments Pertaining To The Proposed Order's Analysis

IAWC continues to restate its arguments and reasons to support the recovery of the Acquisition Adjustment and approval of the SSP. (IAWC Br. at 5-19). We respond below to certain assertions.

As it has throughout, IAWC attempts to make much of its claim that it will not recover any

portion of the Acquisition Adjustment unless it can first prove there are acquisition savings. Seemingly ignored by the utility are the many concerns raised by IWC and the Staff as to the difficulties associated with incorporating acquisition savings in the context of future rate cases. Because the ability to prove or disprove savings is such a dubious task in the context of the SSP, ratepayers do realize a risk of being asked to absorb recovery of the Acquisition Adjustment for nothing in return. Ratepayers would then be subject to paying a cost for service never received and, consequently, unreasonably higher rates.

Next, the utility relies upon its example which it states illustrates the impact of the acquisition and SSP, to show that the customer's bill is eventually lower than it would have been without the acquisition. (IWC Br. at 6). As we explained in the reply brief, what is really occurring is the customer's \$30.00 monthly bill is being artificially increased to \$39.00 to cover the Acquisition Adjustment Revenue Requirement and that without the Acquisition Adjustment, the bill would have been \$30.00. (IWC Reply Br. at 15).

IWC then discusses the various regulatory decisions that it believes warrants consideration by the Commission. IWC offers that the Commission should approve rate making approaches that encourage, not discourage, the acquisition of water utility systems where service improvements or other customer benefits would result from the acquisition. (IWC Br. at 9-12). In response, both IWC and Staff have thoroughly refuted the applicability of the many decisions relied upon by IWC. (IWC Reply Br. at 6-9; ICC Staff Reply Br. at 17-29). Furthermore, there has been no demonstration of the need to "acquire" CUCI - - it is not a failing utility and IWC's interest in acquiring CUCI is more about its business/strategic interests. Finally, it is fair to state there is little, if any, benefit to existing IWC customers from the acquisition. (IWC Initial Br. at 17-18; IWC

Reply Br. at 19-20).

B. The Acquisition Adjustment Is Not Part Of IAWC's Cost Of Service, And Is Not Required To Take Control Of CUCI

IAWC takes issue with the Proposed Order's finding that the Acquisition Adjustment should be disallowed on the grounds that it is not directly associated with the utility's provision of service. IAWC argues this holding is inapposite to certain cases and accounting principles. (IAWC Br. at 19-22).

In response, the facts are the Acquisition Adjustment is not part of the price paid to CUCI for its assets. IIRC witness Michael Gorman testified the only amount of the Acquisition Adjustment that could be recovered through a rate plan, if any, would be limited to a "control premium" acquisition adjustment. This is so, because it is the control premium that allows IAWC to take a controlling interest in CUCI and, thus, be able to manage its assets and operations in a way to effectuate savings. Paying anything more than the control premium is mere surplusage that does not result in ratepayer savings. Paying anything more than the control premium means paying for something not related to the cost of service.

IIRC also notes the position taken by Staff witness Rochelle Langfeldt as persuasive in rejecting IAWC's positions. As does Mr. Gorman, Ms. Langfeldt would consider the Acquisition Adjustment based on the market value of the CUCI assets prior to acquisition, subtracted from the acquisition price. (ICC Staff. Ex. 3.0 at 7). Otherwise, using book value as a baseline for the Acquisition Adjustment calculation results in over compensating IAWC with additional cash flows. Additional cash flows above what the CUCI assets are expected to generate, suggests an approach that overstates the market value. (See IIRC Initial Br. at 7-12; IIRC Reply Br. at 18-19). While IAWC disagrees with the opinions rendered by IIRC and Staff witnesses, it offers no compelling

arguments to prove they are wrong.

Finally, IAWC intends to justify its argument that the Acquisition Adjustment is not a “transactional cost”, arguing various accounting definitions and interpretations of the Uniform System of Accounts as put forth by its witnesses. In response, the Commission knows well that accounting principles do not determine ratemaking adjustments. (Illinois Power Company v. Illinois Commerce Commission (Ill. App. 1993), 254 Ill. App. 3d 293, 626 N.E. 2d 713). The conclusions reached in the Illinois Power Company decision are applicable herein. What is more important and germane, is an understanding of what truly is the Acquisition Adjustment, and how it fits in the ratemaking scheme. In the end, the Acquisition Adjustment is not part of the utility’s cost of service no matter the accounting arguments.

C. The SSP Is A Bad Deal For Ratepayers

Despite the many statements and assertions that the SSP is “fair” and that the Proposed Order’s rejection of the SSP is “unfair”, and that the SSP allows savings to customers with no risk of an “adverse rate impact,” the evidence in the record does not back IAWC. For the most part, IAWC’s arguments are a regurgitation of what has already been offered. Notably, little is provided in specific response to the criticisms rendered by IIRC and the Staff. It is these criticisms that were relied upon in the Proposed Order to reject the SSP.

IAWC states throughout that the SSP results in ratepayers receiving 68% of the total net savings, while shareholders receive 32% of the net savings. (See IAWC Br. at 27). In fact, ratepayers receive only 19.2% of the total net present value Demonstrated Savings estimate (IIRC Ex. 1.0 at 8). This was also noted during cross-examination when the Hearing Examiner asked IAWC witness Ronald Stafford whether it was correct that 20% of the savings would flow to ratepayers and he

stated, “Essentially, that’s correct. 20% would flow to ratepayers and the other 80% would recover a majority of the investment made by shareholders to obtain the savings. The shareholders would not be recovering the full investment from that 80%.” (Tr. at 606-607). IAWC insists on only looking at net savings, and ignoring that its proposal allows it to recover in full the Acquisition Adjustment.

Why is it correct to consider total savings and not net savings? Under the SSP, the Acquisition Adjustment becomes part of the utility’s revenue requirement. The revenue requirement is paid by ratepayers through rates. Therefore, from the perspective of ratepayers and their obligation to pay rates, to the extent acquisition savings are tied to the revenue requirement, consideration of total savings is most relevant.

An additional problem with the SSP and IAWC’s perspective, is the ability to determine savings wanes with time. We address this specific issue below, but it amplifies the inequity in the SSP that basically allows IAWC to recover the Acquisition Adjustment in savings in the near term in contrast to ratepayers. Not until year 13 do additional savings (over the first 10%) flow back to ratepayers. Even IAWC acknowledges in its brief what we perceive to be an inequity in the SSP. (IAWC Br. at 28).

IAWC takes issue with the Proposed Order’s concerns with regard to the 40 year period over which acquisition savings will supposedly accrue. Many arguments are made, but none are convincing.

One of the arguments is that the tracking of savings “is easily accomplished using available data regarding company cost levels and publicly available information.” (IAWC Br. at 30). What is not said, is that the utility cost levels in effect are the combined cost levels for both CUCI and IAWC. In order to fairly measure acquisition savings to CUCI, there would need to be a stand alone cost of



service for that utility. However 1) IAWC does not propose constructing a stand alone cost of service for CUCI and 2) such a hypothetical construct would be difficult to implement in any event. Meaning, the whole notion of being able to ascertain cost savings to CUCI, when CUCI no longer exists and is part of IAWC, rests upon a faulty premise.

IAWC suggests cost assumptions of CUCI as a stand alone company are possible, through the use of traditional techniques. (IAWC Br. at 31). As an aside, it was never clear that IAWC recognized the use of a stand alone cost of service for CUCI. IAWC witness Stafford stated IAWC would not prepare a cost of service study for the CUCI on a stand alone basis. (Tr. at 560). Nevertheless, a major obstacle to what is now proposes is the use of “forecasting, trending, and other techniques to make reasonable estimates of future costs.” These techniques are used in conjunction with existing utilities and not hypothetical utilities. These techniques rely upon existing or historical cost data, which is not available for non-existing entities. IAWC witness Gorman also noted there would be no audited books for CUCI or IAWC on a stand alone basis after the acquisition and, therefore, any effort to quantify savings would be most difficult. (IAWC Ex. 1.0 at 10).

IAWC takes issue with the Proposed Order’s reference that savings tracking over 40 years is difficult, stating that the measurement period between each rate case is what is relevant. (IAWC Br. at 31). In response, savings that are expected to occur shortly after the acquisition will be the same supposed savings that flow from year to year. The labor reductions that come about year to year, are due to the same 25 positions that have been eliminated. IAWC is not necessarily focusing on new and additional reductions in labor in say years 8 or 12, or later. Therefore, the Proposed Order’s statements pertaining to the difficulty in tracking savings over a 40 year period of time are right on the mark. These savings will need to be tracked in some form or fashion, from year to year,

even though there will be intermittent rate cases.

IAWC argues savings sharing plans and forecasts are common in today's ratemaking environment, referring to the Rhode Island decision regarding the New England Electric Systems - EUA acquisition. (IAWC Br. at 32). IAWC trumps up this decision because of the 20 year savings sharing proposal. The Commission should disregard the utility's reliance on this decision.

First of all, the 20 year rate plan, as it were, is by far the exception to the rule. As we demonstrated in examining the cases relied upon IAWC, the vast majority of the rate plans are much shorter in duration. (IIWC Reply Br. at 7-9). In addition, IAWC fails to point out the Rhode Island case represented a settlement among parties, and that the commission was not called upon to decide competing interests as is true in the instant proceeding.

Critically important in the Rhode Island matter, ratepayers received a rate reduction and following the rate deduction, distribution rates were frozen for four years. From 2005 through 2015, distribution rates would be below fixed rate targets in order to avoid further merger savings filings. Here, ratepayers will be subjected to the SSP in rate cases over the next 40 years. Also, the utility was required to submit a filing under which 50% of the savings would be reflected in the company's cost of service until 2019. The utility was also required to submit a second filing by 2007 to substantiate the continued nature of savings.

Finally, in the Rhode Island case the utility was to file a cost of service study for a particular year, using calendar data on a historic test year basis. A measurement year cost of service would be adjusted upward or downward based on the occurrence of any then exogenous events in order to avoid having the merger related savings be artificially inflated or deflated by such events.

In summary, this decision is a vastly different animal than the SSP. The Rhode Island decision

does not support IAWC's cause.

D. The SSP Should Not Be Revised As Proposed By IAWC

IAWC argues the Proposed Order should be modified, in the alternative to the SSP, to extend or eliminate the three (3) year rate case time limit. The utility relies upon the SBC Communications, Inc., Ill. C.C. Dkt. No. 98-0555 (Sept. 23, 1999; Amendatory Order Nov. 15, 1999) and GTE/Bell Atlantic, Ill. C.C. Dkt. No. 98-0866 (Oct. 29, 1999) decisions that have been discussed at length by the parties, and continue to offer no support for IAWC. (See IAWC Br. at 14-17; ICC Staff Reply Br. at 17-18; and, Proposed Order at 36).

E. Response To IAWC Contentions Regarding Section 7-204 (b)

In this particular section of its brief (IAWC Br at 36-40), the utility again threatens that if the SSP is not approved, and the acquisition is approved, then ratepayers could be subject to financial harm. Perhaps this is further reason to reject the acquisition.

Troubling is IAWC's interpretation of the Proposed Order's expectations in the filing by IAWC within 60 days of the final order. Already, IAWC believes it will be able to "recover a small portion of the Acquisition Revenue Requirement" for the early years following the acquisition. (IAWC Br. at 37). This is precisely the argument raised by IAWC in its brief on exceptions. The reference to an increased revenue requirement has already led IAWC to consider a mini-SSP. This is just more the reason why the Commission should heed IAWC's concern raised in the brief on exceptions, and reject the SSP and specifically reject the manner in which acquisition savings would be accounted for in any shared savings plan.

F. Response To IAWC's Statements Pertaining To A Separate Savings Methodology Proceeding

As did IWC, IAWC requests there be clarifying language as to whether the filing of the petition is tantamount to approval of the acquisition, or is the approval of a savings sharing plan a condition precedent to the acquisition. (IAWC Br. at 43). The Commission should clarify its intention. The Commission, to the extent it believes another proceeding of any kind is warranted, should be clear in its order that the acquisition is not approved until the shared savings plan is determined.

## II. RESPONSE TO CITIZENS UTILITIES COMPANY OF ILLINOIS

Though CUCI championed the SSP in the context of its witness' testimony, it offers no exceptions to the rejection of the recovery of the Acquisition Adjustment and its impact on IAWC's SSP. Rather, CUCI acknowledges support for the acquisition.

CUCI does raise the same concerns as did IAWC and IWC as to the import of the filing of the Petition seeking approval of a specific methodology for quantifying acquisition savings, except that CUCI would not want the lack of a defined savings methodology to interfere with the acquisition. (CUCI Br. at 1-2). IWC, to the extent it understands the CUCI position, disagrees. The Commission should not affirm the acquisition until it has decided upon the acquisition savings issue. IWC remains convinced the better approach would be to do away completely with the Proposed Order's 60 day filing requirement for the reasons stated in its brief on exceptions.

## III. RESPONSE TO ILLINOIS COMMERCE COMMISSION STAFF

Staff argues, "if the merger in this docket does reduce costs of providing service, then the Customers should receive that benefit. The Order in this docket should not increase future citizens' revenue requirements above the actual cost of providing service to its customers." (Staff Br. at 2). Staff goes on to provide exceptions that call for an acknowledgment that all savings resulting from

the merger should be allocated to ratepayers, and that to permit an increase to IAWC's revenue requirement in order to recover savings produces the same result as permitting the recovery of merger costs. (Staff Br. at 3). Staff also notes that IAWC intends to file for a rate increase at some point in time and, therefore, ratepayers in the CUCI service territory will see their rates actually increase, and not decrease. (Staff Br. at 3).

In response, IIWC is in agreement with the sentiment of the Staff position. An increase in the revenue requirement to artificially reflect savings is tantamount to recovery of merger costs. We note, again, to the extent there are savings that are realized due to management efficiencies and changes in operation, those savings will flow immediately to IAWC and its shareholders. Thereafter, in the context of the next rate case, ratepayers should enjoy the benefit of those same savings in a revenue requirement as traditionally determined.

Dated this 1<sup>st</sup> day of May, 2001.

Respectfully submitted,

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31281

**STATE OF ILLINOIS  
ILLINOIS COMMERCE COMMISSION**

<b>ILLINOIS-AMERICAN WATER COMPANY,</b>	:	
<b>CITIZENS UTILITIES COMPANY OF ILLINOIS and</b>	:	<b>Docket 00-0476</b>
<b>CITIZENS LAKE WATER COMPANY</b>	:	
	:	
<b>Petition For Approval Of Proposed Reorganization and</b>	:	
<b>Affiliated Interest Agreements, Issuance of Common Stock</b>	:	
<b>and Debt Securities and Assumption of Affiliated Interest</b>	:	
<b>Agreements.</b>	:	

**NOTICE OF FILING**

TO: See Attached Service List

PLEASE TAKE NOTICE that on this 1<sup>st</sup> day of May, 2001, we have electronically filed with the Illinois Commerce Commission, Reply to Brief on Exceptions on behalf of the Illinois Industrial Water Consumers, along with Proof of Service thereon attached.

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PROOF OF SERVICE

STATE OF ILLINOIS        )  
                                      )       SS  
COUNTY OF MADISON    )

I, Edward C. Fitzhenry, being an attorney admitted to practice in the State of Illinois and one of the attorneys for the Illinois Industrial Water Consumers herewith certify that I did on the 1<sup>st</sup> day of May, 2001, electrically file with the Illinois Commerce Commission, Reply to Brief on Exceptions on behalf of the Illinois Industrial Water Consumers, and serve upon the persons identified on the attached service list, both electronically and by depositing same in the United States Mail, in Granite City, Illinois with postage fully prepaid thereon.

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SUBSCRIBED AND SWORN to me, a Notary Public, on this 1<sup>st</sup> day of May, 2001.

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Notary Public

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